DEPARTMENT OF JUSTICE

STATEMENT

OF

JAMES J. O'CONNELL
DEPUTY ASSISTANT ATTORNEY GENERAL
ANTITRUST DIVISION
U.S. DEPARTMENT OF JUSTICE

BEFORE THE

SUBCOMMITTEE ON AVIATION
COMMITTEE ON TRANSPORTATION AND INFRASTRUCTURE
U.S. HOUSE OF REPRESENTATIVES

PRESENTED ON

MAY 14, 2008

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Mr. Chairman and members of the Committee, I am pleased to appear before you to explain how the Antitrust Division evaluates the likely competitive effects of airline mergers. As you know, the Antitrust Division cannot comment on the specifics of any transaction it is currently investigating, such as the proposed merger of Northwest Airlines and Delta Air Lines. In my testimony today, I accordingly will not address the Division's analysis of that transaction specifically. But I am happy to talk about the standards the Division generally applies in evaluating mergers and acquisitions in the airline industry as well as merger and non-merger enforcement actions the Division has taken in the past.

<u>A Brief History of Antitrust Enforcement in the Airline Industry</u>

Since Congress enacted the Airline Deregulation Act of 1978, the Antitrust Division has pursued an active program of enforcement in the airline industry to ensure that consumers receive the benefits of airline competition sought by Congress. During the first years following deregulation, antitrust jurisdiction was divided between the Division and the Civil Aeronautics Board (CAB). Though airlines were generally subject to the antitrust laws, the CAB retained jurisdiction to review mergers and acquisitions. When Congress sunset the CAB in 1985, the

Department of Transportation (DOT) assumed that merger review authority. In the following years, the Antitrust Division played a significant role by investigating the likely competitive effects of proposed mergers and submitting comments to DOT in some proceedings.

Effective December 31, 1988, jurisdiction over airline mergers transferred from DOT to the Department of Justice. In the Department's merger review, it works closely with the DOT to benefit from DOT's substantial data and expertise in the airline industry. Since receiving jurisdiction for antitrust review of airline mergers, the Division has actively worked to ensure that mergers that would threaten to harm competition are not permitted to proceed.

In October 1998, for example, the Division sued to block Northwest Airlines from buying a controlling stake in Continental Airlines. Northwest and Continental were the fourth and fifth largest airlines in the United States at the time. They competed on hundreds of routes across the country, and the proposed transaction would have substantially diminished the airlines' incentives to compete against each other. The Division rejected Northwest's plan to put its Continental stock in a "voting trust" for six years as insufficient to prevent the competitive harm likely to result from the acquisition. In November 2000, after trial had begun, Northwest announced it was selling Continental the shares that would have given it control, retaining only a five-percent share. Because the sale of control remedied the competitive harm, the Division dropped its suit.

In 2001, the Division announced its intent to challenge the merger of United Airlines and US Airways, then the second and sixth largest airlines in the United States, after concluding that the merger likely would reduce competition and result in higher fares on routes throughout the United States and internationally. The Division concluded that United's proposal to divest assets at Reagan National Airport and American Airlines' promise to fly five routes on a non-stop basis were inadequate to replace the competition that would have been lost due to the merger. In response, the parties abandoned their merger plans.

The Division has also successfully challenged other transactions that would have eliminated competition between airlines. In 1993, for example, the Division challenged an investment agreement between British Airways and US Airways after concluding that the transaction threatened competition in gateway city pairs and certain connecting city pairs—in particular, service between parts of the east coast of the U.S. and London, England. As a result, US Airways was required to divest its authority to provide service to London from three of its hubs. The Division has also challenged proposed acquisitions of gates or slots that would have eliminated existing or potential hub competition, including Eastern Air Line's proposal to sell a block of gates to US Airways at the gate-constrained Philadelphia International Airport, and Eastern's proposed sale of slots and gates at Washington National Airport to United, which operated a significant hub out of nearby Dulles Airport.

In addition to challenging transactions that would adversely affect market structure, the Division has investigated and challenged collusion in violation of section 1 of the Sherman Act. In 1992, the Division sued Airline Tariff Publishing Co. (ATPCO) and eight major airlines, alleging that the airlines used the ATPCO electronic fare submission and dissemination system to fix prices, which the Division concluded had cost consumers up to $2 billion in travel expenses. And, in an ongoing criminal probe of major international airlines for fixing rates for cargo shipments (including medicines, food, and consumer electronics) and rates for passenger transportation, more than $770 million in criminal fines have been imposed and guilty pleas have been entered by British Airways, Korean Air Lines, Qantas Airways, and Japan Airlines.

In addition to pursuing these enforcement matters, the Antitrust Division also engages in competition advocacy in various matters before the Department of Transportation. For example, the Division has filed comments in DOT proceedings considering whether to approve and grant immunity to all or part of international airline alliances, matters over which DOT retains authority under 49 U.S.C. §§ 41309 and 41308, respectively. It participates with the Departments of Transportation, State, and others in efforts to open international airline markets, and has advocated for addressing airport congestion issues through efficient market-based mechanisms.

All of the Division's efforts in regard to the airline industry have as their goal the assurance that U.S. consumers recieve the benefits of a competitive marketplace.

General Standards for Evaluating Mergers and Acquisitions

Many mergers raise no competitive concerns and can benefit consumers. However, certain proposed mergers do raise serious competitive issues. Antitrust analysis is highly fact-specific. In each case, we carefully review the facts and the evidence to determine whether a proposed transaction would violate the antitrust laws. The Antitrust Division reviews airline mergers under section 7 of the Clayton Act. Section 7 prohibits the acquisition of stock or assets "where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly." The primary focus is to determine the likely competitive effects of a proposed merger in the future.

The Antitrust Division and Federal Trade Commission (the "Agencies") apply jointly developed Merger Guidelines that describe the inquiry the Agencies follow in analyzing mergers. The unifying theme of the Guidelines is that mergers should not be permitted to create or enhance market power or to facilitate its exercise. Market power for this purpose is the ability profitably to raise prices above competitive levels (or reduce competition on dimensions other than price, such as product quality, service, or innovation), for a significant period of time. In some circumstances, for example, the sole seller in a market (a monopolist) can charge a price higher than what would prevail in a competitive market. Or, where only two or a few firms account for most sales in a market, they may be able to exercise market power by explicitly or implicitly coordinating their competitive actions. And, in some cases, where the merging firms are the closest competitors to each other for a substantial number of consumers, combined they may be able to exercise market power unilaterally, without coordinating with rivals. The likelihood of such competitive effects depends on the specific market facts.

As suggested by the language of section 7, the Agencies generally assesses likely competitive effects in relevant product or service ("line of commerce") and geographic ("section of the country") markets in which the parties to a merger agreement compete, determining whether a merger would likely lessen competition in those markets. The purpose of this inquiry is to ascertain whether there are alternative products and services to those of the merging parties to which customers could reasonably turn in response to a price increase by the merged firm.

After identifying the relevant markets, the Agencies consider a variety of market factors to determine whether the transaction would likely be anticompetitive. For example, the Agencies consider both the post-merger market concentration and increased concentration resulting from the merger. Although market shares and market concentration are instructive, the Merger Guidelines make clear that they provide only the starting point for analyzing the competitive impact of a merger. The Agencies do not make enforcement decisions based solely on market shares and concentration, although both measures are an important part of the analysis. In some cases, for example, new entry (including expansion by fringe firms or re-positioning) is likely to occur on a timely and sufficient basis to frustrate any attempt to exercise market power. Other factors relate to the ability of the merged firm, alone or in combination with others, to exercise market power.

The Merger Guidelines identify two broad analytical frameworks for assessing whether a merger of competitors is likely to substantially lessen competition: "coordinated interaction" and "unilateral effects." A merger may substantially lessen competition through coordinated interaction if, after the merger, competitors could more completely or successfully coordinate their pricing or other competitive actions than before the merger. A merger may substantially reduce competition through unilateral effects if the transaction would enable the merged firm to raise price or otherwise exercise market power without coordinating with its non-merging rivals.

The Agencies also consider merger-specific efficiencies of the kind likely to enhance the merged firm's ability and incentive to compete, potentially resulting in lower prices, improved quality, enhanced service, or new products. For example, a merger may enable two ineffective, high-cost competitors to become a more effective, lower cost competitor. Or, marginal cost reductions may reduce a firm's incentive to raise price after the merger. The Agencies must be convinced that the nature and magnitude of the efficiencies are such that the merger is unlikely to be anticompetitive. Where the potential adverse competitive effects of a merger are likely to be large, the size and certainty of efficiencies resulting from the merger will have to be very substantial.

In evaluating the likely competitive effects of a transaction, the Agencies examine all available evidence, both qualitative and quantitative. We obtain evidence from the merging parties, their competitors, their customers, and other sources, such as consumer groups, government agencies with experience in the relevant industry, and third party experts. The Division relies heavily on evidence from documents and first-hand observations of the industry by customers and other market participants, and in some cases this understanding is enhanced significantly by quantitative analyses of various sorts. By carefully evaluating this evidence, the Agencies obtain an understanding of the market in which the proposed merger would occur and how best to analyze competition.

Evaluating Mergers and Acquisitions Among Air Carriers

The Division applies the Merger Guidelines to mergers in the airline industry. In airline mergers, the definitions of product and geographic market converge: relevant airline markets are likely to consist of scheduled passenger airline service between a point of origin and a point of destination, generally referred to as city pairs. Thus, for example, a relevant market might be Atlanta to Minneapolis-St. Paul. This market makes intuitive, as well as economic, sense. If you want to fly from Atlanta to Minneapolis-St. Paul for a business meeting or vacation, you are not likely to regard a flight from Atlanta to Detroit or Milwaukee, for example, as a reasonable alternative if the fare from Atlanta to Minneapolis-St. Paul goes up. The Division would thus be concerned about a transaction that significantly reduces competition in city pair markets.

The relevant market may, however, also be narrower than all scheduled airline service in a city pair. Certain cities may have multiple airports and, depending on the facts, it may not always be the case that all of those airports are in the same relevant antitrust market for certain consumers. Also, it may be the case that non-stop and connecting (one-stop) service may not be in the same relevant antitrust market. Many city pairs are served by some carriers on a non-stop basis and by other carriers on a connecting basis. This circumstance poses the following question: Do passengers regard connecting service as a reasonable alternative to non-stop service, such that the availability of connecting service would constrain the price of non-stop service?

In the Division's experience, passengers traveling for leisure—on vacation, for example—are more likely to consider connecting service as a good alternative to non-stop service because they are less time sensitive (in other words, their demand is more elastic). But business travelers may be significantly less likely to regard connecting service as a reasonable alternative because they place a higher value on getting to their destination quickly (their demand may be relatively inelastic). A carrier offering the only non-stop service on a route could raise fares to those time-sensitive travelers without losing them to another carrier's connecting service. There thus may be circumstances in which a transaction will be competitively problematic because of its impact on non-stop service in city pair markets, even if other carriers provide service in those markets on a connecting basis.

In considering the possible competitive effects of an airline merger, the Division accordingly looks at the effect in all city pair markets served by both of the merging carriers in terms of both nonstop service and connecting service. Once overlapping city pairs have been identified, the Division looks at the number of other carriers serving each of the markets and at the nature of that service (whether it is connecting or non-stop). Using detailed data that carriers are required to report periodically to the DOT, the Division calculates market shares. It then focuses further analysis on those city pairs in which market shares and concentration levels indicate a post-merger structure conducive to the creation or enhancement of market power.

As I have discussed, the Division's analysis does not stop with the market shares. The prospect of potential competition through entry or expansion by other airlines can constrain the ability of incumbent airlines to raise price or reduce output below a competitive level. Under the Merger Guidelines, the Division considers whether entry into the affected markets is easy, in the sense that it would be timely, likely, and sufficient in its magnitude, character and scope, that it will likely deter or counteract the competitive effects of concern.

The Division also will consider and take into account airline-specific business practices and characteristics that affect merger analysis. For example, in the Division's review and ultimate determination to challenge the merger of United Airlines and US Airways, we were concerned that the merger would reduce competition with respect to high volume corporate and government business contracts. The Division will consider these and other factors in assessing the likelihood that a transaction will create or enhance the merging carriers' market power or facilitate its exercise, on a unilateral or coordinated basis.

The Division also takes into account any efficiencies that may result from the merger. If a merger brings efficiencies that will enhance the combined firms' ability to compete, and the benefits from that enhanced competition will negate any otherwise potential anticompetitive effect, then the merger is procompetitive. A merger may enable the combined airline to offer U.S. consumers better service, for example, by offering more frequent flights between some city pairs, fewer connections, shorter layovers, or service to more destinations throughout the country or the world.

Conclusion

Mr. Chairman, competition in the airline industry is critical for the millions of people who depend on air travel in their business life and personal life. If the Division concludes that a proposed merger will violate the antitrust laws or that air carriers are engaging in illegal collusive or monopolistic conduct, the Antitrust Division takes appropriate enforcement action. Mr. Chairman, this concludes my prepared remarks. I will be happy to answer questions that you or other members of the Committee may have.